



Economic Advisory Council Spring 2019 Meeting Topic Notes

Topic 1: Poverty Reduction through Growth: Assessing and strengthening the linkages through MCC Programs

Background

MCC's guiding objective and mission statement is "Poverty Reduction through Growth". Growth as the main driver of poverty reduction derives from strong empirical evidence of the positive correlation between economic growth and poverty trends over time (Dollar and Kraay, 2003, 2015). It also derives from theory: factor accumulation, rising productivity, and growth in incomes work to not only expand the pie for potential redistributive purposes, but raise the labor and business incomes. Over the long run the correlation approaches 1. This fact underpins the MCC model, together with evidence that (1) foreign aid provided under the right conditions (good governance) is effective in promoting growth (Levy 2014, Burnside, Dollar 2004) and (2) private investment represents the main source for sustained growth in productivity and income.

In general, policies and institutions that expand economic opportunities and raise returns for broad segments of a country's *economy* are likely to drive both poverty reduction and economic growth. MCC attempts to target policies and institutions that will enhance investment and entrepreneurship, and thereby labor, agricultural, and business incomes across a range of sectors with the potential to reduce poverty. This approach underscores MCC's role as an effective aid agency with a clear line of sight to poverty reduction. Nonetheless, under some circumstances, one cannot always assume that efforts to foster growth will result in sustainable poverty alleviation. MCC seeks to understand when and how these linkages may break down, whether at an economy-wide level, or in sectors where MCC invests, and what measures can be taken to strengthen linkages to poverty reduction.

MCC's current practice and economic rationale

For the past decade MCC has utilized the Hausmann-Rodrik-Velasco approach (from Harvard's Center for International Development, 2008) to identifying the investment focus of MCC compacts. Since then, country compacts have been designed around a *binding constraints to growth* analysis, to identify the

specific factors that prevent a country from alleviating its binding constraints. MCC later introduced a link from binding constraints to intervention design: a *root cause analysis*, which unpacks the constraints into greater detail and identifies the issues which cause or perpetuate the constraints. Since 2017, MCC has instituted as a required investment criterion that its projects “alleviate a root cause of a binding constraint to economic growth” (see [MCC Compact Development Guidance](#)). In addition, interventions are subject to rigorous cost benefit analysis (CBA), and the estimated distribution of benefit streams across the population are modeled as well using the logic and data available linked to the CBA, by conventional income categories (extreme poor, poor, near poor, and non-poor). However, MCC’s process typically does not incorporate the distributional impact of an intervention as part of project selection since the analysis is done after cost benefit analysis. Nor does the MCC process include a comprehensive assessment of the obstacles to an intervention’s transmitting benefits to the poor. Understanding whether and how such linkages may be strengthened can serve to help the agency better leverage such benefits.

Questions for MCC practice

Given this context, an issue MCC wants to explore with the Economic Advisory Council is whether MCC’s current growth diagnostics approach, root cause analysis, and program economic analysis continues to best position MCC to deliver sustainable poverty reduction.

Several other aid institutions have adopted specific goals with distributional objectives beyond the elimination of extreme poverty, most visibly the World Bank with its twin goal of supporting income growth and well-being of the bottom 40% (“shared prosperity”). In such cases, significant resources are committed to analysis of the drivers of distributional outcomes. USAID adopted a modified approach to the constraints to growth analysis to bring in ‘social inclusion’, for example by including analysis of labor market impact and the ability of different socio-economic groups to participate in growth opportunities across productive sectors. The IMF has recently published research pointing to greater inequality negatively impacting on growth performance and productivity (Ostry et al 2019), and has modified some specific areas of policy advice to reflect this.

MCC is interested to explore whether greater emphasis should be given to building on the assets of the poor and internalizing distributional analysis of investments and policy reform supported in MCC compacts. Some specific points give rise to questions for further investigation, analysis, and debate. MCC seeks the latest evidence to help it strengthen the linkages between growth and poverty reduction through its programs and poses the following questions for the EAC:

1. With broad-based growth widely accepted as the foundation for long term poverty reduction, when and how should MCC place any additional emphasis on distributional outcomes important for social stability in a manner consistent with its data- and evidence- driven approach to compact design?
2. What is the state of current *theory* and *evidence* on the mechanisms linking economic growth and poverty reduction, or undermining the links? Are there qualifiers on the nature of growth (the “quality of growth”), which argue for attention to special attributes (environmental, distributive, intertemporal)?
3. In which contexts or situations should MCC be concerned about, and commit resources to assess,

obstacles to the transmission of benefits to the poor, in MCC's growth diagnostics, root cause analysis, or economic analysis of interventions?

4. How should MCC take into account the possible negative influence of inequality on growth? Does existing evidence warrant this? How does high or increasing inequality serve to entrench deficits in opportunity, lack of assets, political power or other conditions for the poor?
5. These broad questions give rise to several questions that may warrant further attention in MCC's work:
 - In which contexts is evidence of a negative impact of inequality on growth sufficiently strong to warrant additional policy attention? Are there tools to identify those country or sector contexts? How could such areas best leverage MCC's focus on broad based growth to reach the poor?
 - In countries where evidence on growth incidence shows a highly skewed distribution (e.g. Lesotho with *negative* growth for the lowest deciles), should the constraints to growth analysis be modified to identify growth factors that support a different pattern?
 - Are there key shifts in the growth opportunity set for small open economies with the development of global value chains, disruptive technologies, and other factors reducing employment and returns to labor? How should MCC factor such realities into its approach to the mission of poverty reduction through growth?
 - Poverty is often geographically concentrated in specific regions, and inter-regional migration is one strategy for escaping poverty. Is there a case to be made for subnational constraints to growth analysis, and special attention to lagging regions? Under what circumstances?
 - Can 'good and bad' influences on inequality be adequately distinguished to guide compact design?

Topic 2: Leveraging private financing for development, growth, and poverty reduction

"A paradigm shift on how development will be financed is required to unlock the resources needed to achieve the Sustainable Development Goals. ... ODA must be targeted increasingly to crowd in other funding sources: (i) for Low-Income Countries (LICs), on the basis of poverty, vulnerability, and limited fiscal capacity; and (ii) for Middle-Income Countries (MICs), by playing an increasing role to leverage and catalyze public and private sources of financing"

— (IMF/WB Development Committee, 2015).

Background

There has been much attention to moving 'from billions to trillions' in development financing to low and middle income countries in support of the sustainable development goals (SDGs) *crowding in* private investment. The UN estimates that \$3.9 trillion is required annually for the SDGs, while overseas development assistance (ODA) flows are less than 4% of this. Domestic resources (tax, non-tax revenues) are the most important source of development finance, but low income countries (LICs) remain very dependent on concessional development finance (accounting on average for about 30% of total funding in LICs, but less than 5% in lower middle income countries (LMICs)). Private development finance potentially has a vital role to play in financing the shortfall. It is already the second largest source of

finance in LMICs, but is still tiny for most LICs. In recognition of this, many have called for using foreign assistance to help leverage private financial flows to LICs and LMICs, in particular for physical infrastructure.

MCC has engaged in measures to attract private capital into development compacts from its start. Apart from indirect support through efforts to improve the business environment, MCC compacts in Jordan, Ghana, Liberia, Benin, and Central America have supported private participation in state owned enterprises and have combined private financing with MCC's grant finance to expand the overall financial impact. Pursuant to the Better Utilization of Investments Leading to Development or "BUILD Act", signed into law in October 2018, the US will establish a new Development Finance Corporation (DFC), providing a new impetus in MCC to identify opportunities to leverage private finance for development. The DFC is authorized to make loans, guarantees, take equity positions, provide insurance, extend technical assistance, etc. to facilitate private sector participation in economic development of low or lower-middle income countries. MCC will share its results-focused approach with the DFC, but seeks to also find opportunities to collaborate directly to facilitate private investment in MCC countries, and is developing a strategy for future institutional collaboration.

MCC's current practice

The MCC supports private sector investment and entrepreneurship as the primary driver of sustainable growth to reduce poverty. Country compact development begins with an analysis of the binding constraints to growth, in particular an assessment of constraints to private investment and entrepreneurship. Binding constraints that have been identified cover several areas: deficits in infrastructure services has been the most common (energy, water, transport, etc.), but also human capital deficits, weak land markets and management, and in some instances costly access to finance, high levels of corruption, taxation, costly regulation, and other issues with the business environment itself have been identified as binding (e.g. in Tunisia, Lesotho).

While MCC has traditionally focused on infrastructure projects, emphasis is increasingly being placed on complementary policy and institutional reforms that aim at capacity of the public sector and ensuring sustainability of public services over time. Experience with mobilizing or leveraging private capital in MCC supported development projects (e.g. through credit enhancement, structured finance, or supporting public-private partnerships), is still relatively limited but experience is growing. There have been successful examples of MCC support to public private partnerships for Port construction (Benin), waste water treatment (Jordan), and technical support for structuring PPPs (Guatemala, El Salvador). Grant facilities have helped mobilized private financing (Indonesia, Benin), and attracted independent power producers (IPPs) (Ghana). These examples illustrate the use MCC's grant resources to reduce risks or boost returns to private investors, attracting foreign project financing that would otherwise be unlikely to materialize.

The main objective of credit enhancement, PPPs, guarantees, or other leveraging instruments, whether attracting debt or equity, is to influence the risk-return calculus of private investors to induce them to commit resources. This and other measures (e.g. improving sector governance) may serve to improve the

incentive frameworks for more efficient provision of infrastructure and other services. MCC's authority is limited to using its own grant resources, but in collaboration with the DFC (or other international financial institutions) there may be greater potential for collaborating with other instruments of support.

The extent to which such enhancements or subsidies are necessary or beneficial will depend on the country and project context and the perceived risk factors. Most of the countries where MCC operates are perceived as high risk and low capacity, or sub-investment grade, and are unable to attract institutional capital without some credit enhancement or guarantee. Many lack sovereign risk ratings that provide risk metrics commonly referenced by foreign investors. The lack of ratings is typically a sign of political or macroeconomic instability, or weak rule of law and contract enforcement, which accentuate both political and commercial risk. And *domestic* investors or banks generally lack the tenor or resources to finance large scale infrastructure.

Moreover, to the extent such blended finance, PPP or other private financing opportunities may increase countries' de facto debt burden beyond sustainable levels, this is problematic. Several MCC countries are heavily indebted face macro and fiscal policy challenges, and therefore have limited scope to take on new debt. Foreign currency denominated debt is particularly risky, as the debt service burden is potentially much harder to manage. Macroeconomic and/or political volatility that can weaken the domestic currency and amplify the debt burden. Domestic currency financing avoids or reduces this risk, and may further serve to stimulate domestic financial deepening.

Questions for MCC practice

In keeping with MCC's evidence-driven model, understanding the root causes of sovereign and commercial risk is central to understanding which interventions can be effective and sustainable. It can also guide MCC's efforts to optimally leverage private capital for development purposes. Blended finance can be used, along with policy and institutional reform, to address the root causes of market failures in the provision of insurance or credit (asymmetric information, including principal-agent problems, externalities...), or government failures (high taxes, corruption, poor property rights...). This is the logic behind the Policy Based Guarantee the World Bank has used in a number of countries to combine policy reform (focusing in general on business environment and public financial management reforms) with credit enhancement to attract private capital into development programs.¹ Lessons from the World Bank experience may be relevant to MCC as it explores collaboration with the DFC.²

Given MCC's significant presence in financing infrastructure, MCC often seeks to build the legal foundations, public capacity, and preparation facilities for PPPs or, in the power sector, independent IPP arrangements in partner countries. Opportunities will nonetheless be constrained by MCC's country selection system, as well as limitations imposed by MCC's authorizing legislation. MCC's role in more advanced LMICs with ready access to international capital markets, like Indonesia, may be limited. In low capacity, sub-investment grade countries there may be greater scope for actively employing blended-finance instruments or guarantees, where appropriate.

As with other MCC programs and projects, activities involving blended financing will need to be justified

on the same basis as other programs and meet MCC's investment criteria, including demonstrating that (discounted) social benefits are expected to exceed the opportunity costs of the project capital committed from all sources, as compared with the counterfactual of no such public investment of funds.

Questions to explore:

- What are the main economic issues that should help to guide MCC's support for greater leveraging of finance through guarantees, PPPs, and other mechanisms?
- How can MCC strategically and systematically identify risk factors relevant to encouraging 'blended finance' and capital mobilization? How best can MCC factor macroeconomic risk, debt capacity, and contingent liabilities be addressed in formulating MCC's approach to leveraged finance in sub-investment grade environments?
- Using grant financing to 'crowd in' private capital has a strong intuitive appeal. Are there risks of MCC support *crowding out* private capital inflows, under what circumstances, and how can these risks be assessed and/or mitigated?
- What metrics and tools are available to help identify and prioritize financial leveraging opportunities for MCC, consistent with the model of identified binding constraints and root causes? Are there likely opportunities for blending finance in most countries regardless of the constraints found binding?
- Under what conditions are there likely to be opportunities for **domestic** capital mobilization (local currency) for MCC to explore financial mobilization and support for capital market deepening? What lessons from experience (e.g. GuarantCo, a nonprofit providing local currency finance and guarantees for infrastructure) can guide MCC opportunities? How might MCC's five year fixed compact period limit such engagement?
- Are there particular types of market or institutional failures or other root causes common to LICs or LMICs that underpin high sovereign and commercial risk which MCC focus on?
- Could a model of targeted policy and institutional reforms, accompanied by grant finance support to incentivize institutional investors, be a model in LICs or LMICs for MCC to consider (similar to policy based guarantees)? What relevant evidentiary basis and lessons MCC might draw on for considering such approaches?

Topic 3: Analyzing and Prioritizing Obstacles to Regional Integration

Background

In 2018, the US Congress granted MCC the authority to engage in concurrent compacts for the purposes of regional investments. In principle, this authority may help MCC achieve its mission – to reduce poverty through economic growth – in situations such as where:

- A regional investment strategy would be more efficient in alleviating a binding constraint to economic growth in one or more countries (e.g., by transmitting electricity from a low cost producer to a high cost producer);
- Greater intra-regional trade in goods and services would be growth-enhancing and poverty-

reducing;

- Regionally coordinated policy action (such as in tax, trade, environmental, regulatory, product standards, or foreign investment and competition policies) is needed to solve a costly coordination failure (including by avoiding beggar thy neighbor policies or a “race to the bottom”), or can incentivize domestic governance reforms (such as through regional standards, reporting, and transparency requirements);
- Coordination failures occur that result in the under- provision of infrastructure crossing international borders, such as a trans-border rail line or highway (because each country’s investment would only be viable when the other country also invests);
- There are important economies of scale in the provision of productive factors such as specialized human capital or infrastructure;
- There are important externalities accruing across borders, or finally;
- The costs and benefits of an investment are asymmetric across countries, thus requiring facilitation or compensatory investment by a donor.

Issues for MCC

Consistency with MCC’s current model.

Current model: MCC’s approach to developing its single country compacts is based upon the premise that partner countries have limited financial resources and state capacity, and that policy action requires the expenditure of scarce political capital.³ It also embraces the notion of country specificity: while there are common themes of under-development each country differs in terms of what precisely inhibits its ability to achieve prosperity. Therefore, MCC takes prioritization seriously and begins the development of country compacts with a data-driven identification of binding constraints to (broad based) economic growth. This is followed by an analysis of the root causes of the identified constraint(s), and project scoping and design are meant to flow from these two analytical steps.⁴ Further committing to this approach, MCC recently adopted as one of its investment criteria that projects it invests in “alleviate a root cause of a binding constraint to growth” (see MCC [Compact Development Guidance](#)).

Proposed approach to developing regional investments: MCC’s pursuit of regional investments requires some adaptations to this approach. Recognizing the vast array of potential obstacles to regional integration, MCC has proposed replacing the foregoing investment criterion with the requirement that a project address an economically significant obstacle to growth and poverty reduction through regional integration. Compact development may begin with a project concept proposed by a government, donor, MCC staff, or other stakeholders. Once identified, the problem area implied by a project concept can be assessed for its economic significance and the project for its economic rationale, but without necessarily understanding whether or where more significant obstacles or constraints may lie. At the same time, MCC’s planned approach calls for a stage of problem definition and root cause analysis. This process in some ways reverses MCC’s initial steps which, as described above, are predicated on data-driven prioritization of problems to address. There have yet to be any regional projects selected for investment, but this process could have implications for MCC’s ultimate impact and the viability of projects pursued.

Analytical Challenges

MCC still needs to identify feasible analytical tools to prioritize among regional issues to address.

Context: Notwithstanding the greater complexity of prioritizing constraints in a regional context, MCC would like to establish as data-driven and comprehensive an approach as is feasible for identifying potentially high impact areas of intervention. Theoretical opportunities are vast, as discussed above, particularly as applied to several eligible countries at once. This past December, for instance, MCC's Board selected five countries for the purposes of exploring potential concurrent regional compact programs – Benin, Burkina Faso, Ghana, Ivory Coast, and Niger – with the aim of arriving at a project involving at least a subset of two. For its first concurrent regional compacts, MCC also decided to prioritize sectors where the opportunity for tangible cross border infrastructure investments appeared highest – e.g., the transport and power sectors – along with any associated policy and institutional reform support.

Lack of a feasible prioritization framework: At present, MCC is interested in pursuing a set of agreed, feasible analytical tools to prioritize among regional issues to address. To our knowledge, no accepted analytical framework exists to test the full span of possible constraints to growth through regional integration, such as exists for a single country's growth in the form of the growth diagnostics approach authored by Hausmann, Rodrik, and Velasco (2006). Moreover, those frameworks which could be constructed would appear to require exponentially more data (including, on movements of people, trade in services, prices and price disparities across spatial units) and time to implement than MCC typically allocates to its early analytical steps (approximately 4-6 months).

Approach to date: In its first tentative approaches to this problem, MCC has done the following: (1) estimated gravity models to benchmark country-pairs' level of trade in goods and detect significant deviations from expectation; (2) reviewed existing country growth diagnostics (MCC), Systematic Country Diagnostics (World Bank), and Diagnostic Trade and Integration Studies (UNCTAD), where available; and (3) noted the general implications of comparative indicators on various dimensions of regional integration available from the African Union and the World Bank's *Doing Business*. However, there is little guarantee that with such general yet partial information, the most significant economic obstacles can come into focus.

Challenges: The evidence linking sustained broad-based growth to poverty reduction is compelling (notwithstanding the need to look at the strength of these linkages case by case). However, the poverty implications of regional programs are likely to be more complex. Although even under single country programs one sector or group of producers or consumers may benefit much more than others, under regional integration, based on standard trade theory, there is greater risk that groups of producers or consumers could experience at least short run economic *losses*. Such losses have proven difficult for governments to manage politically or economically. Therefore, the need to understand the likely channels of impact appears even greater for regional investments.

Key Questions for the EAC

1. What are the available analytical approaches to identifying and prioritizing obstacles to growth and poverty reduction with a regional dimension in a given context? What are the most promising avenues to attempt, given typical data limitations and MCC's time constraints?
2. How could the existing theory and evidence on the benefits of regional integration for growth and poverty reduction help *shape MCC's approach* to concurrent compacts, whether in terms of country selection, sector / problem area focus, or approach within sectors?
 - a. To what extent could MCC reduce the scope of its attention to certain sectors *a priori* without a high risk of omitting key constraints?
 - b. Are there certain areas of regional integration that are likely to be most promising for fostering growth and poverty reduction in Africa?
3. What are the main risks in terms of missed opportunities for positive impact of constraining possible avenues to a relatively short list of countries and sectors, and/or of failing to conduct an objective ex ante prioritization analysis? How can such risks be mitigated? What are the potential benefits of this approach?
4. What types of regional projects raise the greatest risk of causing harm to the poor, and how can MCC ensure that the poor are positioned to benefit from enhanced regional integration?
5. Looking forward, are there risks posed by emerging economic trends or 'disruptive technologies' that are likely to be accentuated or reduced through greater regional integration?

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Endnotes

1. Policy Based Guarantees have been sparingly used since introduced in 1999, but recently have gained more traction. A brief instrument description is here (<http://siteresources.worldbank.org/INTGUARANTEES/Resources/IBRDPBG.pdf>).
2. The World Bank's [Independent Evaluation Group has an evaluation of Policy Based Guarantees](#).
3. As Hausmann, Rodrik, and Velasco's 2006 paper, *Growth Diagnostics* points out, given the impossibility of knowing or predicting the sign and magnitude of interactions between potential reforms, the most promising reform areas are those where large *direct* effects on growth are obtained.
4. Gender and private sector analysis are also integrated into MCC's early analysis.